VZCZCXRO1225
PP RUEHPT
DE RUEHBY #0311/01 0852112
ZNR UUUUU ZZH
P 262112Z MAR 09
FM AMEMBASSY CANBERRA
TO RUEHC/SECSTATE WASHDC PRIORITY 1275
INFO RUEATRS/DEPT OF TREASURY WASHINGTON DC PRIORITY
RUCPDOC/DEPT OF COMMERCE WASHINGTON DC PRIORITY
RUEHDN/AMCONSUL SYDNEY PRIORITY 4402
RUEHBN/AMCONSUL MELBOURNE PRIORITY 6184
RUEHPT/AMCONSUL PERTH PRIORITY 4447
RUEHWL/AMEMBASSY WELLINGTON PRIORITY 5697
RUEHKO/AMEMBASSY TOKYO PRIORITY 3472
RUEHBJ/AMEMBASSY BEIJING PRIORITY 9417
RUEHLO/AMEMBASSY LONDON PRIORITY 2033
RUEHRL/AMEMBASSY BERLIN PRIORITY 1076
RUEHFT/AMCONSUL FRANKFURT PRIORITY 0352
RUEHBS/USEU BRUSSELS PRIORITY
RUEHFR/AMEMBASSY PARIS PRIORITY 1542
RUEHOT/AMEMBASSY OTTAWA PRIORITY 2307
RUEHME/AMEMBASSY MEXICO PRIORITY 0331

UNCLAS SECTION 01 OF 02 CANBERRA 000311

SENSITIVE
SIPDIS

STATE FOR EEB AND EAP/ANZ

TAGS: EFIN ECON AS
SUBJECT: GOA GUARANTEES STATE DEBT AND BORROWINGS

REFTEL: 08 CANBERRA 1036 (NOTAL)

¶1. (SBU) Summary. The GOA announced on 25 March 2009 that it would guarantee an estimated US$120 billion ($A170 billion) in existing and projected State government debt to overcome a severe funding problem affecting major infrastructure projects. Treasurer Swan said the chance of a default was 'remote' and insisted State governments pay a fee for the 'temporary' guarantee. The policy change immediately cut the cost of State borrowing, but has increased the exposure of the federal government. It may also affect international markets for sub-national government debt. End Summary.

TEMPORARY GUARANTEE ON STATE GOVERNMENT DEBT

¶2. (SBU) Announcing a guarantee of State government debt after a meeting with state treasurers, federal Treasurer Wayne Swan said the GOA would provide "a time-limited, voluntary guarantee over state government borrowing." This federal guarantee will be temporary and not a "free ride". The states have 28 days to accept the guarantee for existing debt which only applies to state borrowings in Australian dollars. Under its terms, AAA-rated states will pay a fee of up to 30 basis points for the federal guarantee; while AA+ rated states such as Queensland and Tasmania will pay up to 35 basis points.

¶3. (SBU) The new guarantee will lower Queensland's borrowing costs by $A200 million in 2009-10. It has an immediate impact, lowering the difference between Queensland and Federal bonds by 35 basis points, and between New South Wales and Federal bonds by 25.5 points. In return, the federal government will benefit from fees paid for the guarantee by both the States and the banking sector, which could reach A$3 billion over 5 years. Notably, since the GOA's October 2008 guarantee for bank debt (reftel), Australian banks have raised over A$85 billion in longer term debt (1-5 years), paying fees of A$600 million in the first year and A$2.5 billion over five years. The ANZ Bank has raised A$20 billion (with a fee of A$539 million); while Macquarie Bank has raised A$14 billion, but will pay the second highest fee of A$502 million as it has a lower credit rating. Due to the guarantee, investors should be more willing to lend to states (and banks) at lower rates as the Rudd government will repay State debts and loans in the improbable event of a state government default.

¶4. (SBU) The new guarantee will require federal legislation, and

Swan appealed for the Coalition to support it "in the national interest". Opposition Treasury spokesman Joe Hockey has criticized the uncapped plan but Swan indicated the loans council process, would "keep an eye on" total borrowings and what the borrowed money was being used for. Ratings agency Standard & Poor's said the decision to explicitly guarantee state debt will have no impact on Australia's AAA sovereign rating, which "already factors in all state debt".

STATE GOVERNMENT BOND MARKETS REVIVED BY GUARANTEE
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¶5. (SBU) The guarantee was announced because state bond markets were not functioning well. Investors preferred to buy federal government bonds, or those issued by Australian banks, which had already received a federal guarantee, diverting investment into the more liquid, AAA-rated bank debt, and away from state debt. The yield gap between federal and state government debt had widened in late 2008 as the Rudd government rejuvenated the federal debt market by beginning to issue bonds for its fiscal stimulus programs. Each State will decide whether it needs the guarantee to raise funds for infrastructure spending on road and rail projects and for other purposes. Currently, NSW, Victoria, South Australia and Western Australia are rated AAA by Standard & Poor's while Queensland and Tasmania are one step lower at AA+.

¶6. (SBU) The pressure to accept the guarantee will increase as State revenues fall due to the global economic crisis; and the impact of lower commodity prices on royalties and taxes on the mining sector. Western Australia is still AAA rated but is under threat of a downgrade to AA because of its expanding fiscal deficit. Similarly,

the AAA rating of NSW is on "negative watch". Queensland was recently downgraded to AA due to its plans for expanding debt-financed infrastructure at a time when revenue is falling sharply (with a cut $A8 billion in the current budget). The guarantee is temporary, and the federal government expects states will stop using the guarantee when credit markets normalize.

¶7. (SBU) Comment: While federal and state government debt in Australia is currently reasonably low (the federal government was almost debt free a year ago) it will inevitably surge in the future, when there could be a very congested market in AAA-rated debt. The Treasurer's mid-year economic update pointed to gross debt heading of A$140 billion but this figure will be revised upwards in the May budget. Federal debt obligations will also include expanding state debt (due to their deteriorating budgets and growing infrastructure spending). Further, the Rudd government will carry a contingent liability of up to A$1 trillion-plus of bank and other deposits, as well as the national net foreign debt of around A$600 billion. One possibility is that the Australian-dollar-denominated debt market will be over-supplied. Another is that Australia's sovereign AAA rating could be downgraded if overall debt increases sharply - with significantly greater funding costs for all sectors. Finally, the Australian guarantee may have ripple effect in the global sub-national bond market, with other issuers facing pressure to seek similar guarantees from their national governments. End Comment.

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